ECONOMICS FOCUS

Two kinds of openness

Many argue that Asia's ex-tiger economies collapsed because they were too open to international finance. It would be more accurate to say that they weren't open enough

MUCH of the blame for the economic crisis in Asia and in emerging markets across the world has been laid at the door of "global capital". For years, the familiar argument goes, rich-country investors piled into these poor but fast-growing economies, drawn by the promise of much higher returns than they could ever expect at home. But the resources, as it turned out, were not well used: much of the inflow went on speculation in stockmarkets or property, to pay for industrial projects that had no sound commercial rationale, or sometimes merely to line the pockets of ministers, officials and their friends.

When this became apparent, at the start of what might otherwise have been a mild economic downturn, the foreign investors turned and fled. Having encouraged waste and reckless risk-taking hitherto, by making capital too easily available, they now cut the supply of new finance altogether, regardless of economic fundamentals, and withdrew as much as they could of what they had invested already. As a result, Asia's downturn became a rout—a spreading calamity that is causing terrible hardship in the countries concerned and which might yet drive the world as a whole into recession.

This version of events, which is true so far as it goes, lies behind demands that emerging-market economies should reintroduce, or cancel any plans they had to remove, their controls on cross-border flows of capital. The merits of that idea are challenged elsewhere in *The Economist* this week: the analysis is wrong even if the narrative is correct. But whatever the strengths and weaknesses of that case, it has become muddled with another question, related yet distinct, and just as important—the question of financial openness, more broadly defined.

In the financial ghetto

Openness requires not only that borrowing and lending can flow across borders, but also that people and firms be free to buy internationally traded financial services, and that foreign banks and other financial firms can enter domestic markets to compete with the incumbents. In many countries, rich and poor alike, governments restrict these additional freedoms, and treat their financial-services industries as enclaves—even while maintaining in other respects an open capital-flows regime. The converse is also true: financial-services industries can in principle be made to compete with foreigners even if capital flows are in other respects controlled.

So there are two kinds of openness. The second kind, openness to competition, is indeed connected to the first, openness to capital flows. But far from being a part of the capital-flows “problem”, financial competition is in fact a large part of the solution to it.

The conventional wisdom is right to say that the shocking vulnerability of Asia’s financial systems had much to do with domestic defects. Before the crisis struck, as it now appears, banks throughout the region had mountains of bad debt—mountains that official figures turned into molehills. (The extreme case is South Korea: officially, non-performing loans in its banks were less than 1% of all lending in 1996; corresponding estimates of outside observers ranged between 15% and 30%.) Lax supervision, weak management, woefully poor control of risk, and a habit of lending to connected firms or at government behest were chiefly to blame. Add a surge of foreign capital to that lot and you are indeed asking for trouble.

The question is, why did these defects persist? Doubtless for many reasons, political as well as economic—but one answer is that these are hallmarks of protection, of financial systems sheltered from outside competition.

Before the crisis, the ex-tigers all restricted the entry of foreign-owned banks. They may have been open or semi-open to capital flows, but from an institutional point of view their financial systems were comparatively closed. In the mid-1990s foreign-owned banks accounted for roughly 5% of bank lending in South Korea, Thailand and Indonesia—about the same share as in India, though more than in Japan, whose financial system is also in an appalling state.

In contrast, the corresponding figure for Chile, nowadays the exemplary exponent of capital controls, was more than 20%—about the same as in the United States. Chile does not restrict entry by foreign banks; more than half of its banks are foreign-controlled. By this yardstick, in other words, Chile was more open than the ex-tigers.

And that has probably contributed to its financial soundness. The prudential record of rich-country banks is hardly unblemished. Even so, they would have helped to expose and correct Asia’s problems in several ways. Competition would have driven down costs, including the costs that go with cronyism. It would have imported experience of (and demands for) better standards of data, risk control, internal oversight and external supervision. It would have brought in new technology. And it would have made the region’s troubles more manageable by promoting financial diversification. Asian subsidiaries of rich-country banks would have been far more robust in the face of financial shocks than the locals proved to be: unlike the locals, they don’t have all their risks in one small place.

As it happens, the crisis is beginning to force open Asian finance. This owes less to intellectual conviction than to the pressing need for the region’s governments to rebuild their banking systems. For that, inward investment by foreign banks will prove invaluable. And it is a trend the IMF is keen to encourage. Many will find that puzzling: it seems to repeat the mistakes of the past. In fact, it helps to correct them. Whatever you think about capital flows, this is one respect in which global finance is definitely friend not foe.

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